FRBSF Weekly Letter

December 27, 1985

Credit Card Controversy

Credit cards are once again in the financial news. The current controversy centers around the failure of credit card finance charge rates to follow the decline in other market interest rates. Consumer groups and some members of Congress have recently protested that bank card finance rates, which average about 19 percent nationwide, are usuriously high given the relatively low average cost of bank funds, currently estimated to be less than 10 percent (see chart). As a result, three bills have been introduced into Congress that would establish a nationwide usury ceiling on credit card rates.

Credit card issuers have countered by arguing that the current level of bank card interest rates reflects the realities of pricing a complex product in a highly competitive marketplace. Besides finance charges, other pricing decisions include the level of annual fees, the billing cycle to be used, the length of the interest-free grace period, the types of enhancements included, and various other late fees and service fees. Bankers note that the cost of money to fund credit card operations represents only a fraction (typically 40 percent or less) of the overall cost of operating a credit card plan. Other costs, which include various processing and billing expenses and fraud and credit losses, are significant and do not vary with the cost of money.

This *Letter* examines the nature and scope of the credit card product and its use within the U.S., and offers some observations on the possible implications of a nationwide usury ceiling on credit card rates.

Motivation for card use

It is estimated that Americans were using 700 million credit cards, or more than three cards per capita, to purchase nearly $300 billion worth of goods and services at the beginning of 1985. The popularity of credit cards is probably due to the numerous advantages they offer as a payment device. The nature of these advantages, moreover, has spawned two generally distinct patterns of credit card use among consumers. The first is "convenience" use in which card users emphasize the transaction nature of their credit cards by regularly paying their outstanding balance in full each month and incurring no monthly finance charges. The second is "revolving debt" use in which the credit card is used as a source of credit by individuals who only infrequently pay their entire outstanding monthly balance.

Each method of use offers certain advantages over cash, checks and other means of payment. Convenience use minimizes the need to carry cash, allows the user to defer payment for goods and services for a short time, and establishes a payments record of purchases. Convenience users can also use their cards to bridge gaps between income receipts and expense disbursements. In certain cases, too, consumers who use credit cards can exercise their legal right to withhold payment for goods of disputed quality.

Revolving debt users, in addition to realizing the above advantages, benefit by being able to vary debt to match exactly the amount of the purchased good and to avoid the need to file multiple credit applications (as in the case of personal loans, for example). Thus, the use of a credit card is a more convenient and less time-consuming way for consumers to take out a loan. And, unlike fixed payment personal loans, revolving debt users also have considerable flexibility in the timing and amount of debt repayment.

Card holdings and usage

Credit cards are an important fixture on the U.S. financial scene because of the services they provide businesses and households. Of the different types of cards used in the U.S., those issued by banks and retail stores account for both the greatest percentage of cards held (nearly 70 percent) and the highest level of spending. Other types of credit cards, such as gasoline and travel and entertainment cards, are less widely distributed and account for a significantly smaller share of receivables.

The *1983 Survey of Consumer Finances*, a government-sponsored survey which included approximately 3,800 representative U.S. families, provides important insights into card use patterns and the characteristics of card users. The survey indicates both current use and the dynamic pattern of adjustment to changes in credit card pricing.

Nearly two-thirds of all U.S. families hold at least one credit card — a fraction that has risen slightly in recent years. Moreover, there have been important shifts in the types of credit cards held by U.S. families because of basic changes within the credit card industry. The imposition of annual fees for bank cards in the early 1980s, for example, resulted in a decline in multiple holdings of bank credit cards. Today, fewer than 40 percent of U.S. families hold more than one bank credit card, and less than 10 percent hold more than two. Consumers have also reduced their holdings of gasoline credit cards as a result of the increased acceptance of general purpose cards such as VISA and MasterCard for gasoline purchases. Still, the total number of both bank and nonbank cards held and used has grown during the 1980s.

Relatively wealthy and educated individuals tend to be the most frequent users of credit cards. For example, the 1983 *Survey* reveals that more than 90 percent of families with annual incomes of $50,000 or more reported regular use of their credit cards. The usage rate is similarly high in families in which the head of the household is a college graduate. Usage rates decline steadily with decreasing income and education, although this decline is gradual and limited. The 1983 *Survey* indicates, for example, that the usage rate is approximately 50 percent even for families with annual income as low as $10,000. Thus, all but the poorest families appear to be active users of their credit cards.

Implications of proposed legislation

The current controversy over the level of credit card interest rates has stirred some Congressional interest in establishing a national usury ceiling on such charges. To date, three legislative measures have been proposed. If enacted, these measures would create a formula link between credit card rates and either the discount rate (HR 1197), the three-month Treasury bill rate (HR 3408), or the IRS penalty rate (S 1922). Currently, these bills would generate maximum allowable card rates of between 10 percent and about 13 percent — considerably below the national average of approximately 19 percent.

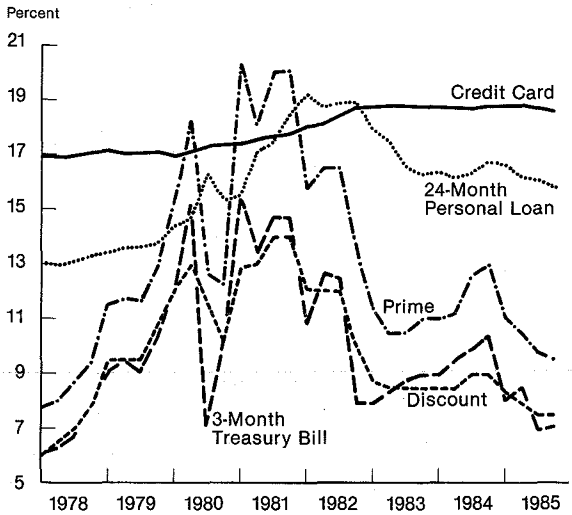
A nationwide usury ceiling on credit cards would have the effect of lowering interest charges paid by revolving debt users. It would also, however, probably generate a variety of other secondary effects that would adversely affect card issuers, merchants, and all credit cardholders in general.

Given that about 60 percent of revenues of bank card plans are derived from finance charges, a significant reduction in card interest rates would undoubtedly reduce the profitability of bank cards. As profits declined, card issuers could be expected to attempt to reduce credit losses by rationing credit. One likely response would be the imposition of stricter credit standards for new card applicants. Such a response, however, would particularly harm low income families by making it difficult for this group to obtain a credit card.

Businesses that accept bank credit cards and their customers could also be harmed by a usury ceiling. If banks were to attempt to maintain pre-ceiling revenue levels, they could choose to raise the amount of the discount that merchants must incur (typically 2-5 percent) when they present credit card receipts to banks for collection. An increase in the merchant discount would not only lower profits on retail credit card sales, it could also invoke price increases as merchants attempt to regain previous profit margins. Such price increases could also occur in the case of retailers that offer their own credit cards.

Ironically, all credit card holders are also likely to be adversely affected by a usury ceiling. This is because the benefits of a usury ceiling — lower interest charges — would be realized by only a portion of the cardholding public. Certain costs arising from the imposition of such legislation, however, are almost sure to be borne by all cardholders. Evidence from the 1983 *Survey* indicates that 47 percent of card users "nearly always" pay their outstanding monthly credit card balances in full and thus incur no finance charge. An additional 26 percent (73 percent combined) "sometimes" pay in full. Only 27 percent of the respondents indicated that they "hardly ever" pay their monthly balances in full and thus consistently incur a finance charge. The direct benefit of lower interest rates, therefore, would probably be realized by the less than half of all card users that use their credit cards as a source of revolving debt.

Credit Card Rate vs Other Interest Rates



Additional costs

The additional costs imposed by the likely pricing adjustments of card issuers, however, would be borne by all cardholders, convenience and revolving debt users alike. If revenues are reduced by lower finance charge rates, card issuers are sure to respond by trying both to raise revenues in new ways and to cut costs. To raise revenues, banks and retailers could alter the billing cycle used to calculate interest charges, shorten or eliminate the interest-free grace period, or impose late fees and service fees. In addition, banks could raise annual card fees and reduce the value of enhancements (such as travel insurance and card registration services).

Two other comments seem relevant. First, it is not clear that a usury ceiling is needed to ensure the availability of lower interest credit card plans. At least one industry newsletter and, more recently, a Congressional sponsor of HR 3408 have provided evidence of numerous card plans that stipulate an interest rate below that of the national average. In some cases, the interest rate charged was as low as 13 percent, or about six percentage points below the current national average. Such data would seem to suggest that lower credit card rates are already available to those cardholders for whom the finance charge is an important consideration. Of course, prospective cardholders would be wise to consider all aspects of any particular card plan since many of these low-interest credit cards feature shorter grace periods, higher annual card fees, and more stringent credit standards.

Furthermore, it is likely that a national usury ceiling — especially one that is pegged to a variable interest rate such as the three-month T-bill rate — would create costly compliance and enforcement problems for card issuers and regulators. Federal law and some state laws require prior notification of changes in credit card finance rates (some states require more than one notice). In addition, some states require that outstanding balances incurred under the prior interest rate be maintained and charged separately from those incurred under any new rate. Thus, it is possible that during a period of fluctuating interest rates, considerable effort and expense would be incurred by cardholders, card issuers, and regulators to implement and keep track of segmented, multiple interest credit card accounts.

Conclusion

The existence of two modes of use for credit cards — convenience and revolving debt — indicates that consumers differ as to which features of the credit card product are important to them. Convenience users are likely to favor lower annual card fees and care less about the level of finance charge rates. Revolving debt users are more likely to be concerned with finance charge rates and credit availability than with annual card fees and enhancements.

These different credit card holding and usage patterns suggest that the beneficial effects of a usury ceiling on credit card interest rates are likely to be unevenly distributed. At best, only a portion of card users would benefit since many cardholders are convenience users and consistently avoid paying interest charges. More likely, a national credit card rate ceiling would adversely affect the non-interest aspects of credit card pricing for all cardholders, and could reduce credit availability if funding costs rise again. A usury ceiling could restrict opportunities for consumers to make tradeoffs among finance charge rates, annual fees and other terms of card pricing. There is evidence that significant interest rate differences already exist among card plans. Card users that are sensitive to interest rates, therefore, might benefit more from seeking out a low-interest card plan than from usury legislation.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/4/85	Change from 11/27/85	Change from 12/5/84 Dollar	Change from 12/5/84 Percent[7]
Loans, Leases and Investments[1] [2]	198,931	458	11,400	6.0
Loans and Leases[1] [6]	180,359	555	11,330	6.7
Commercial and Industrial	51,858	55	– 1,009	– 1.9
Real estate	65,759	90	4,221	6.8
Loans to Individuals	38,051	7	6,833	21.8
Leases	5,426	– 1	351	6.9
U.S. Treasury and Agency Securities[2]	11,231	– 111	– 385	– 3.3
Other Securities[2]	7,341	14	455	6.6
Total Deposits	203,775	– 111	9,194	4.7
Demand Deposits	51,440	– 308	4,461	09.4
Demand Deposits Adjusted[3]	33,767	603	3,602	11.9
Other Transaction Balances[4]	14,989	651	1,921	14.7
Total Non-Transaction Balances[6]	137,346	– 454	2,811	2.0
Money Market Deposit Accounts—Total	45,874	137	5,340	13.1
Time Deposits in Amounts of $100,000 or more	37,960	– 525	– 2,464	– 6.0
Other Liabilities for Borrowed Money[5]	27,798	1,681	5,496	24.6

Two Week Averages of Daily Figures	Period ended 12/2/85	Period ended 11/18/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	68	40
Borrowings	148	19
Net free reserves (+)/Net borrowed(–)	– 79	21

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change